Economic Importance of the Corporate Bond Markets

ICMA
International Capital Market Association

**First edition
March 2013**

ICMA represents participants of all types - issuers, investors, and intermediaries - in international fixed income bond markets. As a long-standing self-regulatory organisation, setting standards and monitoring good practice in these markets, we strive to maintain high standards of market conduct that support the needs of the global economy. We support good regulation and vigilant supervision of our markets, and vigorous enforcement action against malpractice. Trust between market participants is essential for effective markets and prosperity. For more information about ICMA, see www.icmagroup.org. ICMA is grateful to Timothy Baker for his help in drafting this paper.

Summary

This paper by the International Capital Market Association (ICMA) is about **why corporate bond markets are so important** for economic growth, for investors, for companies, and for governments, around the world; and why it is therefore essential that laws and regulations that affect them avoid any unintended adverse consequences that could inhibit those markets.

Corporate bonds - transferable debt securities issued by companies - are one of a range of means, alongside equity share capital, bank lending, and other methods, by which **companies fund their business needs and their expansion.** (see section B(i) below)

Corporate bonds have long been a particularly **stable and reliable source of term finance for non-financial-services companies** in the 'real economy'. **The importance of corporate bonds for issuing companies** has grown, particularly as bank lending has been squeezed, and is likely to continue to grow. Bonds are a pivotal mechanism for creating and sustaining enterprise, business investment, and economic growth. (see section B(ii) below)

Corporate bonds offer a range of **advantages to investors,** in particular for individuals and funds that need stable and predictable income and retention of capital value, for example to save for retirement. They are an important means to stimulate private investment and limit citizens' dependence on the public sector. (see section C below)

Primary and secondary **markets in corporate bonds link corporate issuers and investors efficiently around the world.** Domestic and international corporate bond markets provide for diverse needs. Domestic markets cater in particular for smaller, growing companies, and domestic investors. International markets - the constituency of ICMA and the prime focus of this paper - enable large companies and conglomerates to draw on global pools of capital, including those which represent the savings and pensions of individuals, for major development projects; and they enable institutional investors to obtain well diversified and consistent returns. The existence of different markets helps today's start-ups and smaller enterprises grow into tomorrow's major companies, by helping them to generate wealth while graduating smoothly into more sophisticated and international financial and investment environments. (see section D below)

Corporate bond markets are also **important to governments** to help meet the urgent global public policy challenges presented by ageing populations, and the need to maintain growth whilst remedying the imbalances that led to the 2008 market turmoil. They help limit government indebtedness, whilst offering investors an alternative to government bonds. (see section E below)

In general, wholesale corporate bond markets have worked well, but retail investment in corporate bonds has been more constrained. **We need to enable wholesale markets to meet investors' and companies' needs even better, and to build on the success of wholesale corporate bond markets by encouraging more retail involvement.** This is a task for both the markets themselves, and for the authorities. Markets, legislators, and regulators need to work together to provide the optimal environment for corporate issuers of bonds, and investors in corporate bonds, to thrive. (see sections A and F below)

Good conduct in these markets is vital. So is good regulation of them. Intermediary firms - ICMA's members - are subject to ICMA standards of good practice, and to applicable national laws and regulations. Rules, whether promulgated by industry bodies or imposed by the authorities, can have beneficial or benign or harmful effects. Sometimes good intentions are thwarted by unintended consequences. It is easy, for markets as well as the authorities, to get things wrong. There are widely expressed concerns, for example, that current legislative proposals implementing the Third Basel Accord, introducing Financial Transaction Taxes, regulating Short Selling, and updating the regulation of European Markets in Financial Instruments, will damage liquidity in the secondary market, with consequent harm to the primary market. **We think it is important for all interested parties: legislators, regulators, market intermediaries, and market users, to work together, with a better dialogue at an early stage of policy development,** to help the authorities understand the markets and the possible effect on them of different measures, and to enable the markets to understand the authorities' policy intentions and advise on the best technical ways of meeting them. (see section F below)

Everyone has a common interest in corporate bond markets that work well for the private and public good. This is important for the authorities and for market participants because if we do not get it right, enterprises and citizens - who are both taxpayers and customers of the market - will suffer. The authorities, and reputable firms, understand the need for user-oriented regulation and market conduct. But there are people who do not. That is why **we are keen to work together with legislators and regulators to discuss public policy needs in a technically neutral way: to promote good regulation and prevent malpractice, but to ensure that avoidable and unintended problems are avoided.** (see section F below)

A. Introduction

(i) Purpose of this paper

Corporate bonds have long been a stable source of finance for companies, and so for economic growth.

Amongst a range of financing methods, bonds - transferable debt securities - have been an extremely important, reliable, and cost effective source of financing for companies around the world for decades. The market disruptions of 2008 and subsequent years underlined the critical role they play in transmitting finance around the world to enterprises in the real economy, generating growth, employment, and prosperity. Bond markets for non-financial-services corporates are growing. They have increased in importance since 2007 (Dealogic statistics, Graph 8: $600 billion issued in 2007; $1.2 trillion in 2011; $1.8 trillion in 2012) as bank lending has declined (Graph 10: $4.5 trillion in 2007; $3.5 trillion in 2011; $3 trillion in 2012). They are expected to be a substantially more important tool for the economy going forward.

We need to build on the success of wholesale corporate bond markets, and encourage more retail involvement.

ICMA works with market users and authorities worldwide to foster and develop the understanding of the cross border bond market, of which the corporate sector is an important component. Without going into great technical detail, this paper aims to help policy makers to understand the critical role played by this bond market sector; how it serves the needs of the companies and investors that use this market; how it helps achieve broader economic and public policy objectives; and the features that need to be safeguarded when shaping policy so as to support its role and to avoid unintended side effects. Some parts of the market work well, but others are less well developed. For example, despite the aim of the EU's 1999 Financial Services Action Plan, Europe's retail market in corporate bonds remains much smaller than the United States'. In Europe it is still easier to buy a share than a corporate bond, even though bonds are in many ways less risky. This paper considers how corporate bond issuance helps provide strength and stability to companies, investors, and economies; and why we need to encourage it.

(ii) Scope of this paper - the corporate bond market and its relation to other funding and investment sources

This paper is about corporate bonds - transferable debt securities issued by companies.

In this paper we use the term 'corporate bonds' to refer to transferable debt securities issued by companies, as distinct from public sector debt, and from non-negotiable debt such as syndicated loans and bank loans. We discuss corporate bonds issued by non-financial-services corporates, distinguishing them from bonds issued by banks. There is also an important distinction between the lending for a term in corporate bond markets, and the maturity transformation function of banks that use short-term deposits from retail customers to support their lending. We are not advocating that greater retail participation in corporate bond markets should compete with or substitute for banks' deposit-taking function.

Corporate bonds are one means of financing among several.

The corporate bond market is just one sector, albeit a vital one, of the wider market in capital. As well as sovereign and supranational borrowers, a range of participants in the economy, from SMEs to multinational conglomerates, and financial institutions of all sorts, compete to borrow investors' funds to put them to good economic use. For the corporate sector, bonds are one component in the mix of funding methods which also includes equity capital and retained earnings, bank loans, syndicated loans, and other forms of borrowing.

Domestic and international corporate bond markets cater for diverse needs.

Within the corporate bond sector, particular segments play crucial roles. International markets, together with the domestic markets, provide the additional capacity and the international access needed to ensure that capital flows freely to those who can use it. Domestic lending and corporate bond markets cater for corporate issuers and investors who do not want foreign exchange risk. But domestic markets are often not big enough for large companies and multinationals seeking large sums for major business development projects, whose needs can be met by the much larger pool of investors in the international corporate bond markets. And domestic markets cannot cater for foreign currency requirements of multinationals, who wish to match their funding currency with that in which they incur expenditure. ICMA's constituency is the international markets, which are therefore the focus of this paper.

Wholesale corporate bond markets have worked well, but retail investment has been constrained.

In both domestic and international markets, there are wholesale and retail segments. On the whole, the wholesale corporate bond markets, where experienced professionals participate without the need for heavy regulation, have performed satisfactorily. We should foster the success of wholesale corporate bond markets and make sure policy and regulation does not needlessly constrain them. However the retail markets, where the greatest scope for growth in investor participation and economic benefit lies, have developed less well. Business conduct regulation is necessary to encourage and protect participation by ordinary investors. But retail markets need significantly more encouragement if increasing demand from investors is to be met with adequate supply. The distinction between wholesale and retail markets is not a straightforward dichotomy. For example, an important policy choice is whether retail investment in corporate bonds is to be enabled directly, or channelled through fund management intermediaries which participate in the wholesale market. While protecting retail investors, we need to make sure that professional investors are not constrained from continuing to fulfil and take responsibility for their professional decision-making.

Bond funding of financial services companies also greatly benefits the economy.

The scope of this paper is primarily non-financial corporates, but it is important to note that the corporate bond market also includes banks, insurers and other companies in the financial sector. Though it has declined since 2007/8 (Dealogic statistics, Graph 8: $1.8 trillion in 2007; $1.4 trillion in 2012), the bond financing of financial institutions also greatly benefits the real economy and can help to finance the recovery, enabling banks to fund trade finance, project finance, consumer credit, syndicated lending, mortgages through covered bonds, and other services which indirectly finance the real economy.

B. Corporate issuers

Corporate bonds are an important, and growing, source of finance for companies in the real economy.

Non-financial corporates have been, and will continue to be, the main engines of sustainable growth in the real economy in the medium and longer term. Corporate bonds are an important and growing source of finance for them.

(i) The position of bonds within the corporate funding structure

The main characteristics of corporate bonds vis-à-vis other funding methods:

Companies typically use a mix of sources of funding to finance their growth and business development. Some is self-funded from retained cash. External sources of funding include long and short term bank loans, syndicated loans by a syndicate of banks and perhaps institutional investors, trade finance, short term (less than one year) capital market debt, corporate bonds, equity share capital, and other forms of hybrid capital.

ranking in insolvency;

Where corporate bonds rank in the capital structure of a company depends on the specific terms of the issue. Secured debt is typically repaid, on the insolvency of the issuer, out of the proceeds of sale of the security and therefore ahead of unsecured debt, and both are paid ahead of equity.

cash flows;

Corporate bonds provide predictable cash flows for both issuers and investors: payment of capital at issue; regular payments of interest; and return of capital at maturity. Secondary market prices fluctuate according to general interest rate expectations and the creditworthiness of the issuer. Bond finance is generally cheaper and less risky for companies than equity finance, where dividend payments depend on uncertain profitability, dividend expectations drive market valuations, and so investors demand greater returns to compensate.

tailoring as the company grows.

Companies' choice between bank and bond debt financing is typically influenced by the company's size, the state of market development, and the availability and relative costs of different forms of finance. SMEs typically seek bank or tailored funding, or tap the syndicated loan market. As they grow they may issue bonds, initially in their domestic bond market, and in the international markets as their needs exceed the investor capacity of the domestic market, or as the international nature of their business demands better management of foreign exchange or other risks. The stages at which this progression takes place may vary between countries depending on the level of development of their bond markets. Some emerging markets remain heavily dependent on bank finance. Larger and more developed markets, particularly in the United States and increasingly in the European Union, have mature domestic bond markets and substantial international activity. Dealogic statistics (Graph 1) suggest that the worldwide volume of international bonds has overtaken that of domestic bonds since 2008.

(ii) Advantages to companies of bond funding

Corporate bonds provide companies with stable funding;

Corporate bond markets benefit issuing companies by providing secure, stable and flexible funding for their enterprise, innovation, technological development, economic growth, trade, employment, and wealth creation. Investors (often insurance companies or pension funds who need to finance long-term cash flow commitments on behalf of retail investors) typically buy to hold to maturity. Secondary market turnover is significantly lower than in equity markets.

lower cost of capital;

Corporate bonds compete with other sources of capital, such as equity or commercial bank lenders, exerting downward pressure on companies' costs of funding. There is a continuing need to reduce the cost of issuance. But disintermediation between issuers and investors and a high degree of competition between the underwriters and brokers who provide support services mean that corporate bond markets help issuers minimise their cost of capital. This allows efficient allocation of investor funds to corporate enterprise, maximising economic benefit.

alternatives to bank finance;

Bond funding reduces companies' reliance on banks, whose ability to lend is from time to time stressed - for example, in the years following the 2007/8 financial turmoil, by reformed prudential regulation, and by banks' need to deleverage their balance sheets in response to the Third Basel Accord. Deleveraging may have a disproportionately large impact on the real economy where banks have been most prominent in debt financing, unless corporate bond issuance can take up the slack (Dealogic statistics, Graph 2: in Europe, Middle East, and Africa, corporate loans declined from $1.4 trillion in 2007 to $600 billion in 2011 and $400 billion in 2012). Bond funding is in any case important when growing companies' finance needs exceed the capacity of their relationship banks, so that they must seek a broader and possibly international investor base. It also functions as a 'spare tyre', enabling continuation of financing even when bank lending and other sources of finance are not available.

cost saving through disintermediation;

Non-financial-services companies are in many cases now regarded in the market as being as good a credit risk as banks, and in some cases better. Before 2007/8, banks could borrow more cheaply than corporates, and lend on. Since 2007/8, a decline in market confidence in banks, deleveraging, and new capital regulation has reversed the position, so it is no longer so commercially viable for banks to intermediate (Bloomberg statistics, Graph 12, and Deutsche Bank research, 31st January 2013). Corporates are well placed to attract funds for the longer term from institutional and retail investors directly, through the bond market. There may well be a long-term shift towards a greater proportion of market-based funding and bank disintermediation.

a means to 'term out' from bank lending;

The existence of developed bond markets does however facilitate the bank loan market, where it is often important for corporates to have bank facilities for a temporary period, and banks will lend in the knowledge that the debt will be 'termed out' in the debt capital markets at some future stage and the bank will be repaid.

a range of instruments and markets for growing business needs;

Bond markets offer a range of types of instruments and markets to cater for companies' needs as they grow, providing a mechanism for expanding SMEs to graduate from domestic markets into international bond markets.

project-tailored funding;

Bond markets offer flexible funding of ongoing business needs and development projects (Dealogic statistics, Graph 9, suggest only minimal use of bond proceeds to fund mergers and acquisitions), as companies make a succession of bond issues to coincide with budgeted cash flows.

beneficial tax treatment;

Governments typically recognise and encourage the economic importance of bond funding through favourable corporate tax treatment of bond interest.

matching of cash flows;

Bonds have a fixed investment term, determined at the choice of the company, enabling it to match a bond's maturity with expected business cash flows. Bonds can thus avoid maturity mismatches in cash flows more efficiently than is possible through bank loans, and minimise the economic risks of 'maturity transformation' - the risk of mismatch in the timing of flows of money resulting from short-term deposits being used to make long-term loans. By providing a fixed amount of capital for a fixed period on terms tailored to their needs, bonds offer companies flexible and targeted funding by comparison with equity.

efficient use of working capital;

Well-functioning corporate bond markets facilitate efficient use of working capital, helping to avoid the need (as occurred in the aftermath of the 2008 financial turmoil) for companies to hoard cash on their own balance sheets because of fears that stressed banks or frozen capital markets may not be able to meet their future funding needs.

efficient exchange risk management;

International corporate bond markets provide access to a range of different currencies, helping companies to avoid exchange rate risk for foreign projects and international trade. For example, if source materials for an infrastructure project are needed from a particular country, an international bond issue in that country's currency can work better than a domestic bond issue which would require the additional risk of further foreign exchange transactions to guard against currency movements. Where the funds are required in the borrower's own currency, it is often more cost-effective for companies to borrow in a foreign currency and manage the exchange rate risk through derivative markets.

access to an international investor base;

International corporate bond markets enable issuers to access a global pool of investors' savings: they are not restricted to domestic sources, as bank loans tend to be. This internationality is essential for the scale of funding and foreign exchange management needed by international conglomerates. It is also a vital source of international funding for developing the economies of emerging countries. And it gives corporates in the developed world access to new and growing pools of investment in Asia, South America, and elsewhere.

encouragement of high standards of transparency and corporate governance.

By virtue of the information demanded by institutional investors, corporate bond funding encourages higher standards of corporate disclosure and transparency, and promotes consistent high-quality international corporate governance standards. The corporate bond market is more transparent and less volatile than the funding provided by alternative investment vehicles such as hedge funds, which may increasingly be competing to fill the gap left by the shrinkage of bank lending.

C. Investors in corporate bonds

Corporate bonds offer a range of advantages for investors.

A range of different sources of finance from around the world seek to invest in companies through international corporate bond markets. The switch in investor appetite from shares to interest-generating assets, so far focused in some jurisdictions such as the EU on government bonds, should be allowed to extend also to corporate bonds. While the result would be more competition between public and private sectors for bond investment, we believe that improved ability for investors to finance private enterprise would provide an overall economic benefit.

(i) Landscape of investors now and in future

The investor base for corporate bonds...

The range of investors includes individual retail investors, individuals investing collectively through pension funds and other managed funds, institutional, corporate, and sovereign wealth investors. Investors' needs vary depending on their risk appetite and future cash flow needs. Corporate bond markets cater in particular for investors not seeking to make returns from dividend growth or increases in volatile capital valuations, but instead seeking consistent and reasonably reliable cash flows and security of invested capital. There is particular scope for greater investment in corporate bonds by retail and collective investment funds that need to match inward cash flows with payment obligations, in particular in those markets where bank deposits, government bonds, and equity shares have historically dominated savings and investment.

...is likely to grow given current economic and demographic trends.

In the developed world more people with increasing life expectancy will need to save for old age in order to fund their long-term financing requirements. Demographic trends in the developed world make it essential for investors to save appropriately for lifetime financing needs and to reduce reliance on state pensions. To do so, individual investors, pension funds, and life insurers need access to suitable debt products to build predictable, safe, and relevant streams of income to meet their liabilities over both the short and the very long term. For the defined benefit pension schemes which wish to move out of equities in order to provide a match for their long-term liabilities, but which find (as for example in the UK) that the supply of index-linked government bonds is too small to match demand (Towers Watson's 16th October 2012 research suggests a long-term shortage of supply of UK index-linked gilts in the next few decades), corporate bonds would provide an additional investment outlet to fill the gap. The same problem, and the same solution, may also apply in the case of retail investors who wish to invest directly. As the affordability and relative importance of defined benefit pensions declines, corporate bonds offer a transparent and relatively secure and diversified element of the funded pension investment mix for retail investors. Decent savings products in turn enhance investors' wealth and give them the confidence to spend.

(ii) Advantages of corporate bond investment

Corporate bonds offer investors a stable form of investment

Corporate bonds offer investors relatively secure term investment and predictable cash flow - regular income payments through the life of the bond, together with the return of the initial capital at maturity, or the early realisation of market value at sale in the secondary market if the investor's cash flow needs change. A bond permits, through its transferable nature, realisation of investment. However, if retail investors need such a facility, regulators will need to facilitate liquidity, for example through market making arrangements. Bonds offer relatively secure real returns, potentially higher than from bank deposits, but with more predictable investment income and capital security than is available with equities. As such they assist efficient investment of savings, particularly for investors needing to generate income.

with good information and basis for valuation;

Corporate bond issuance with its requirement for a prospectus and institutional investors' demand for exchange listing promotes greater availability of information for investors and informed assessment of credit risk. The secondary markets provide a key valuation measure for investment returns.

diversification from other forms of loan investment;

Corporate bonds facilitate diversification from other types of investment - public sector bonds, bank deposits, equities. At a time when many governments are trying to limit or reduce public borrowing, corporate bonds offer investors who have previously invested in public sector bonds an alternative means of investing through lending, either directly or by pooling through institutional investors, that would not otherwise be available to them. While some institutional investors do participate in the syndicated loan market by taking participations in loans made by banks, many do not because such investments are difficult to liquidate in case of need: so the bond markets offer a better mechanism for investment through lending for them too.

international diversification;

International corporate bond markets facilitate diversification of investment between currencies and countries in different stages of the economic cycle. They enable investors to earn better and more diversified returns by accessing a global pool of investment opportunities.

good matching to cash flow needs.

The range, number, and frequency of corporate bond issues facilitates diversification and tailoring of maturity, credit quality, interest rate, and currency risk, enabling a close match to investors' needs and risk appetite. They offer institutional investors flexibility and the ability to time flows of funds at maturity to match their payment obligations.

D. Corporate bond markets - the mechanism that links corporate issuers and investors

Primary and secondary markets link corporate issuers and investors efficiently around the world, and fulfil important economic functions.

The purpose of financial markets is to bring together investors seeking to provide funds, and economic actors seeking to use them, matching them in ways that maximise the benefit for both, and achieve broader economic and public goals. Corporate bond markets provide a very efficient, flexible, and safe mechanism to connect investors across the world with companies in the worldwide real economy who require funding. They allocate growing private savings pools to productive investments; provide finance to companies needing to expand; encourage broader ownership of productive assets; and provide facilities for competitive transfer and transfer pricing of capital resources.

Their characteristics and dynamics differ markedly from other markets.

Corporate bonds differ from other markets, such as equities, in specific ways. Companies typically have very few classes of equity, but many different issues of bonds with different terms and maturities (for example, in 2009, some 7,000 shares were admitted to trading on EU markets, whereas there were 150,000 debt securities in issue (Xtrakter statistics). This pattern reflects companies' typical use of bonds to raise funds for particular time-limited investment projects or business needs.

They provide a continuum of services for different types of company.

The international corporate bond market caters for larger and multinational companies the scale or international character of whose markets requires cross-border participation. Typically companies may graduate from domestic to international markets as they grow. International markets thus form a key part of a continuum of corporate lending markets that facilitates the emergence of smaller companies into international expansion and prominence.

Primary issuance is the dominant market.

Most of the trading activity in corporate bonds takes place in the primary market at issuance, or shortly thereafter. Investment firm intermediaries help the issuing company to structure the issue to match its finance needs and investor demand and minimise the frictional costs of intermediation; they also underwrite the issue and take on the risk of placing it with investors, providing the company with immediate security of funding.

Trading in secondary markets is typically infrequent and in large size. Market makers play an important role.

For issuing companies the term of the bond is fixed. But investors who buy at issue can sell the bonds, which are marketable securities, in the secondary market if they need rapid access to their money. In these circumstances it is the market purchaser of the bond that reimburses funds to the initial investor, not (as in the case of bank deposits) the borrower. Secondary corporate bond markets are characterised by much larger and fewer trades than equity markets. This means that market makers have a particularly important function to provide liquidity on demand to investors needing to sell. Average bond trade size is in the region of €1 to 2 million, with many trades above €5 million; average equity trade sizes are typically 100 times smaller (Xtrakter statistics). Unlike equities, in which trading takes place mostly on stock exchanges and other multilateral trading facilities, most secondary market trading in the international bond market takes place bilaterally over the counter (OTC). Nevertheless the transparency requirements of listing on exchanges provide the information needed for informed valuation. Most trading activity is concentrated at or shortly after issue. This is because, whereas investors often buy and sell shares frequently in response to movements in prices and dividend expectations, they typically hold bonds to maturity in order to fund expected future cash flows. Only about 2% of bond issues trade once a day or more (Xtrakter statistics).

Confidence is sustained by consistent documentation and market processes.

Standardised documentation and issue processes, with high levels of transparency and regulation, have contributed to an effective and efficient corporate bond market in which participants have confidence and where standards are high. Transparency leads to efficient pricing and transfer pricing of capital resources, promotion of high standards of corporate conduct, and encouragement of credit. While liquidity in the secondary bond market suffered in the aftermath of the 2008 financial turmoil, corporate bond markets have continued to function.

E. Why we need to encourage corporate bond funding and markets

Corporate bond markets can serve economic needs while helping meet a range of urgent global public policy challenges.

Vibrant corporate bond markets have numerous benefits for companies, investors, economies, and governments, and can help meet a range of urgent global public policy challenges.

They bring substantial economic benefit;

As IOSCO and the World Bank recognise, corporate bond markets for non-financial companies have intrinsic economic benefits to recommend them. They minimise the friction and cost of intermediation between issuers and investors. They optimise management of cash flow and currency mismatches between issuers and investors. They promote efficient diversification and allocation of available funds in the economy to the most productive uses.

taking the strain off public sources of funding;

In current uncertain times, corporate bond markets harness capital and enterprise in an efficient way that has the potential, with returning confidence, to take strain off public sources of funding. They ease pressure on public funding by growing the private sector. They fulfil key policy objectives of yielding investors income and long-term value, and providing long-term economic sources of funding for issuers.

efficiently channelling new worldwide sources of finance;

They provide an effective means by which new sources of finance - including the savings of emerging economies, the expected increase in private savings resulting from public sector retrenchment, and the expected increase in savings and private pension provision for ageing populations - can be invested most productively to support the real economy, promote worldwide prosperity, and boost growth.

easing pressure on bank lending;

They ease pressure on bank lending, particularly longer-term lending, and allow a wider range of corporate credits to access investment markets and seek finance than the banks or government agencies could provide.

substituting for lending capacity lost in the recent financial crisis;

They replace lending capacity that has evaporated as a result of deleveraging by and declining market confidence in banks. They offer an additional funding mechanism for companies, providing additional capacity if they have a significant need, and continuing finance if bank funding is not available.

promoting investor vigilance.	They promote broader investor interest in, and vigilant credit assessment of, productive corporate wealth creation.
enhancing wealth;	They enhance wealth from secure investment, potentially leading to higher spending.
promoting stability;	They promote stability in times of economic stress, reducing reliance on and exposure to the banking sector in case of future shocks.
reducing vulnerability to crises;	They reduce vulnerability of savers, investors, and economies to bank collapse.
knitting together international investment;	They can integrate international markets to reduce structural imbalances in stable ways, promoting globally consistent productive investment and risk management and helping to maintain international solidarity and global growth at a time when other economic and political pressures may tend towards isolationism or protectionism.
funding essential economic activity;	They contribute predominantly to funding of either ongoing general purpose business needs, or specific projects for innovation, investment, or growth by companies.
and funding social needs.	By providing funding for housing associations, universities, transport networks, and other institutions that provide social benefits, corporate bond markets also directly benefit public policy objectives.

F. The impact of regulation, taxation, and other public policy issues on the corporate bond market

Public policy, laws, and regulation need to be well adapted to the economic function of corporate bond markets, and not unintentionally inhibit them...

The corporate bond market will be affected by worldwide regulatory reform, and by other public policy initiatives that impinge on all financial markets. Policy, legislative, regulatory, and fiscal developments need to be well adapted to support the vital functions in the real economy that the corporate bond markets (both domestic and international) perform: raising money for vital projects that the equity markets or bank loans might be unable to fund as effectively; and allowing institutional and individual investors to meet continuing liabilities with consistent and regular income streams. Financial market policy as a whole must not unintentionally inhibit bond markets, and must achieve the optimal interaction between investors and issuers.

...to support a broadening of the corporate bond market...

Historical examples show how regulation, legislation, and other aspects of public policy can either encourage corporate bond markets to flourish, or inhibit them. At present, access to the bond markets tends to be limited to larger companies, primarily because of the high cost of issuance. But the corporate bond market is broadening out; the range of issuers who now have access to it has increased, and can reasonably be expected to increase further. The costs surrounding the issuance process need to come down in order for more companies to consider this as a viable route to funding. It is important that policy and regulation supports these companies' ability to access the bond markets at reasonable cost.

...and to be reviewed to ensure that the overall framework of control is well adapted to companies' and investors' needs.

In addition to giving attention to the effect of specific new regulatory and policy initiatives, there may be a need for a thorough review of the overall legal and regulatory framework as it has emerged from recent regulatory reform to ensure that public policy and regulation enable markets, including the international corporate bond markets, to optimise interactions between issuers seeking funding and investors providing funds. It is important to check that the post-2007/8 landscape of law, regulation, taxation, and other controls and constraints on the market provides a diversity of policy treatment that fosters different products and market sectors, the economic functions they fulfil, and the issuers and investors they serve. Recognising the importance of domestic bond markets, particularly for retail investors and SMEs, it is important to ensure that the policy mix also allows for issuer and investor participation in international markets, to maximise choice and opportunities, and to ensure that incentives to encourage or discourage investment in different sectors are economically optimal.

It will be important also to consider other non-bank markets in lending.

As well as the international bond markets, which mainly serve large and established companies, it may also be important to consider how other evolving non-bank markets in lending, involving more direct interaction between issuers and investors - such as retail bond markets, private placements, and peer-to-peer lending - can improve access to funding by SMEs, which are likely to be a particularly important engine of both market and economic growth in the short term; and how best retail investors can be assisted to meet their need for increased saving through corporate bond investment.

History shows that some regulatory initiatives have worked well…

Examples of successful regulatory policy focus occur mainly in the wholesale markets, where, for instance, the EU conduct of business rules cater for the needs and professionalism of institutional investors by treating them as eligible counterparties under the EU Markets in Financial Instruments Directive (although they can elect not to be), meaning they are not overburdened by consumer protection requirements. Equally, institutional investors are qualified investors for the purposes of the EU Prospectus Directive and therefore outside its scope. This approach is a major reason why the EU institutional market has developed as it has. Further improvement in these markets needs to focus on such matters as reductions in the costs of issuance for companies, and removal of requirements (statutory or otherwise) for institutional investors to invest in bonds admitted to the regulated markets, which brings the bonds within the listing and prospectus regimes and adds to cost as explained below.

while others have had unintended harmful consequences.

Examples of policy mistakes of the type we need either to reverse or avoid in future, often arising from domestically-oriented legislation that does not fully consider the international and global consequences, include:

(a) The deadening effect of consumer protection regulation in retail markets. For example, under the directives that were replaced by the EU Prospectus Directive (the Public Offer Directive and the Consolidated Admissions and Reporting Directive), translation requirements, local tax disclosure in prospectuses, lengthy prospectuses and short form summaries that are not well adapted to the information needs of retail investors, and draconian liability regimes all tend to drive issuing companies away from retail offers and back to wholesale markets. This inhibition of retail involvement was (and to a large extent, despite the Prospectus Directive, remains) very unfortunate, given that this is the area where, given the demographic changes that we are undergoing, there are likely to be huge increased savings looking for a sound home, as the state sector in many countries seeks to transfer pension and old age provision responsibilities to private actors. So policy and regulatory changes are essential if those savings are to be channelled into the real economy and if the state is to succeed in its ambition to shift the burden.

(b) The US Interest Equalisation Tax of the 1960s and 1970s, intended to improve the US's balance of payments and encourage domestic investment by taxing investment in foreign securities, is a well-known example of the unintended consequences of ill-focused policy, driving the US market in foreign companies' bonds offshore, where it has remained ever since.

(c) Uncoordinated withholding tax policy is a recurring source of uncertainty and cost for retail and institutional investors in corporate bond markets, and has a particularly deadening effect on retail markets. Unilateral withholding of tax from interest paid to foreign investors disadvantages those investors and so deters them from investing: at worst they cannot recover double tax, and at best there is a delay before they are reimbursed the excess tax paid. Either way, international investment is inhibited.

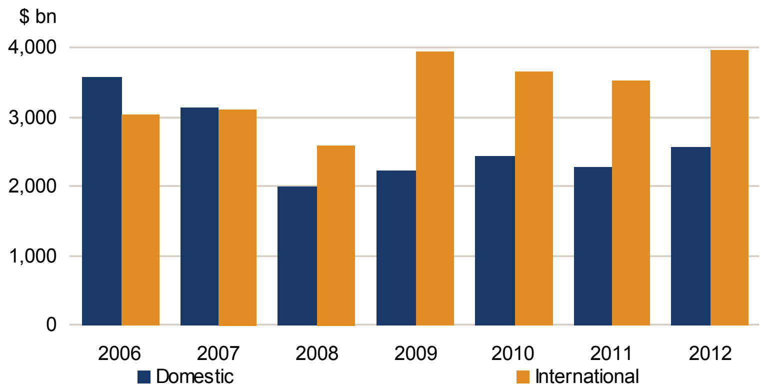
Good regulation and good conduct work together. ICMA is keen to work with the authorities worldwide at an early stage of policy development, to ensure that we all understand public policy needs and the best techniques for meeting them, and that we avoid both malpractice and unintended harm to market users.

Current areas where concerns are widespread about the impact of new regulation on the ability of corporate bond markets to fulfil their economic function effectively include: the effect of legislative proposals implementing the Third Basel Accord on intermediaries' ability to support the market; the impact of financial transaction taxes on market participants; the narrowness of market making exemptions in EU short selling Regulations as a limiting factor in investors' ability to hedge their corporate bond trades; and the adaptation of updated EU Regulations on Markets in Financial Instruments to the special liquidity characteristics of corporate bond markets described above. Careful calibration and adjustment will be vital to protect liquidity in the secondary market and avoid consequent harm to the primary market. Good regulation of corporate bond markets is as vital as good conduct in them. Intermediary firms - ICMA's members - are subject to ICMA standards of good practice, and to applicable national laws and regulations. Rules, whether promulgated by industry bodies or imposed by the authorities, can have beneficial or benign or harmful effects. Sometimes good intentions are thwarted by unintended consequences. It is easy, for markets as well as the authorities, to get things wrong. That is why we think it is important for all interested parties - legislators, regulators, market intermediaries, and market users - to work together, with a better dialogue at an early stage of policy development, to help the authorities understand the markets and the possible effect on them of different measures, to enable the markets to understand the authorities' policy intentions and advise on the best technical ways of meeting them, to promote good regulation and prevent malpractice, but also to ensure that avoidable and unintended problems are avoided.

Annex: Statistics

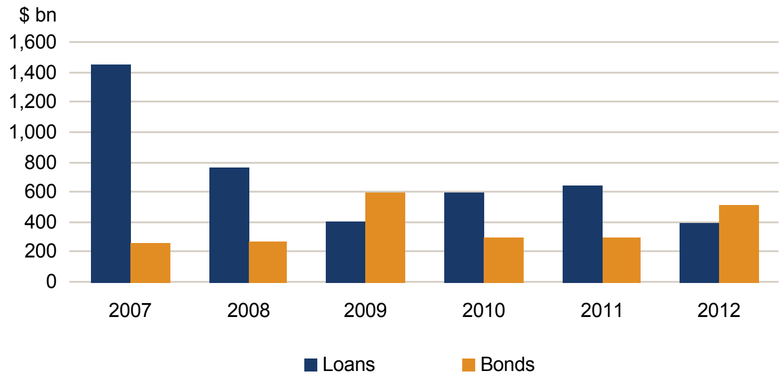
This Annex includes graphs sourced from Dealogic data, except for the graph on bank funding and general corporate funding costs, which derive from Bloomberg data. The graphs relate to a range of aspects of the corporate bond markets discussed in this paper. Data for 'international' bonds relate to transactions marketed to international investors.

Graph 1: International v domestic bond volumes



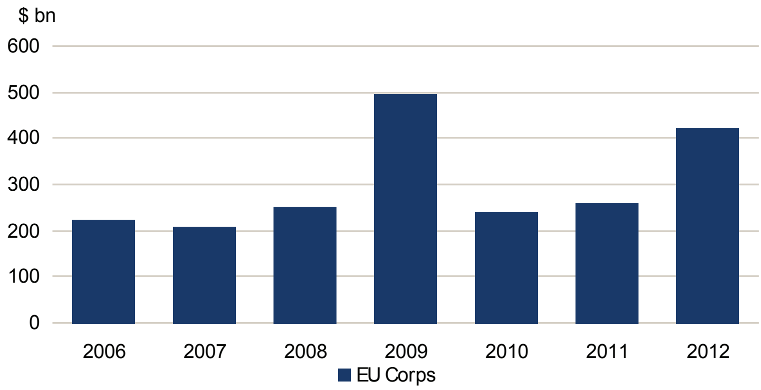
Source – Dealogic, 26 February, 2013

Graph 2: EMEA corporate loans v corporate bonds



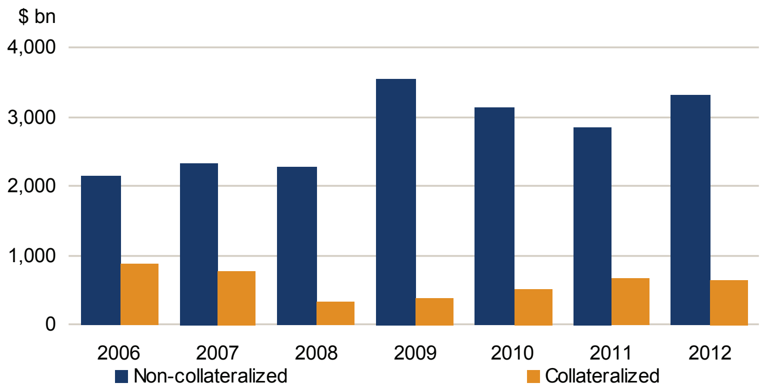
Source – Dealogic, 26 February, 2013

Graph 3: EU corporate bond issuance



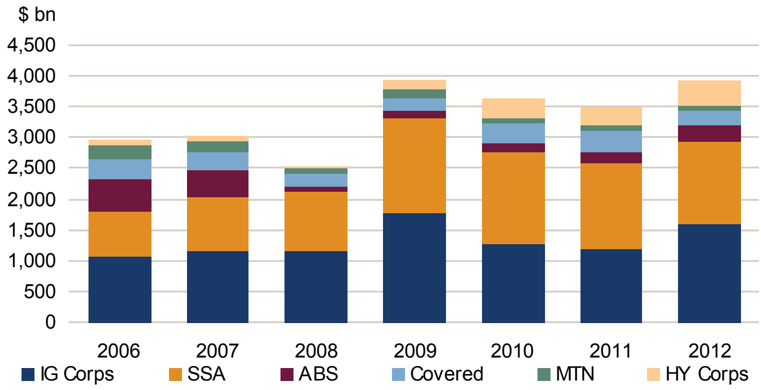
Source – Dealogic, 26 February, 2013

Graph 4: Collateralised all international volumes



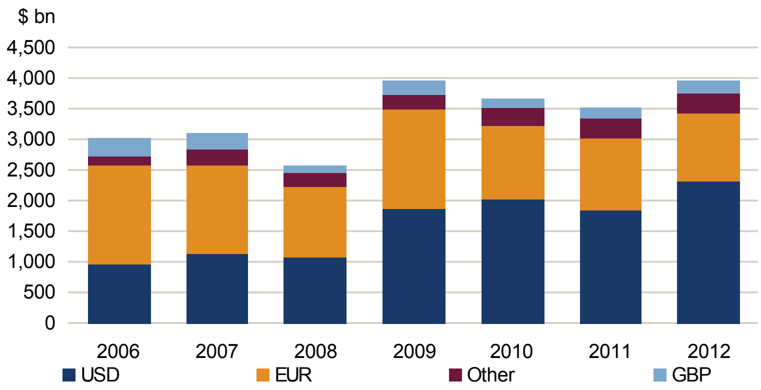
Source – Dealogic, 26 February, 2013

Graph 5: All international bonds deal type breakdown



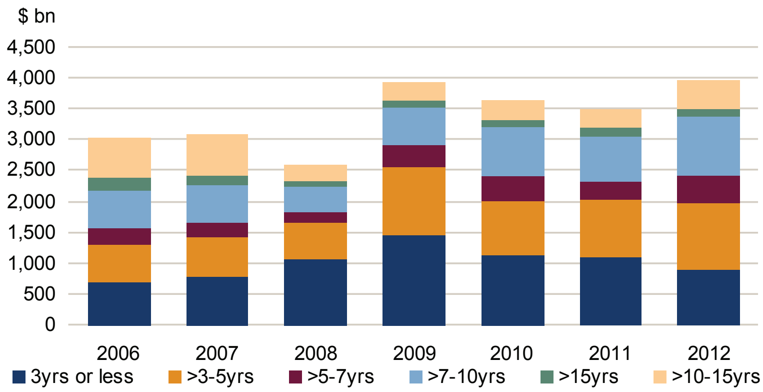
Source – Dealogic, 26 February, 2013

Graph 6: All international bonds currency breakdown



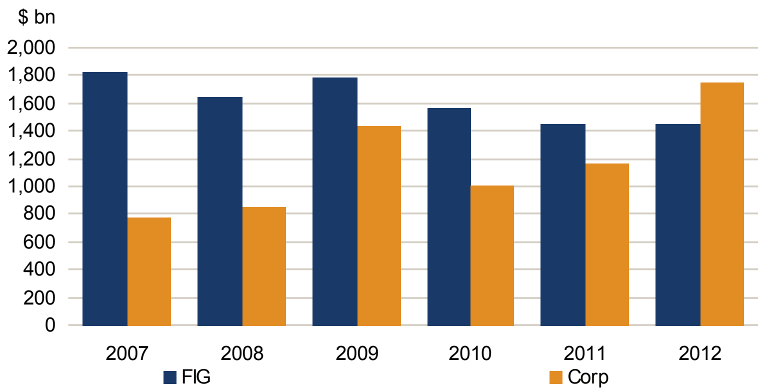
Source – Dealogic, 26 February, 2013

Graph 7: All international bonds tenor breakdown



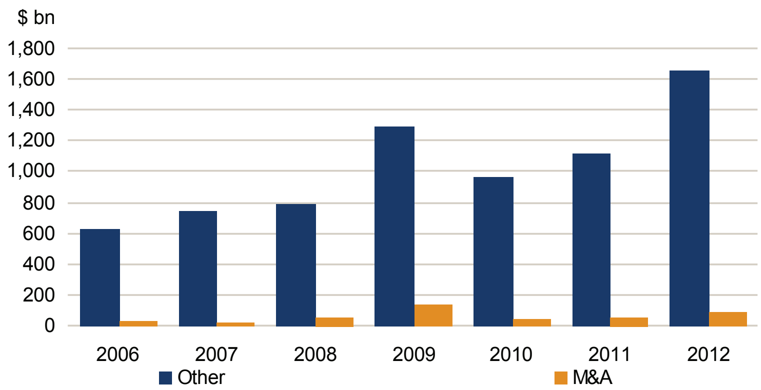
Source – Dealogic, 26 February, 2013

Graph 8: Global financial institutions v other corporate bonds



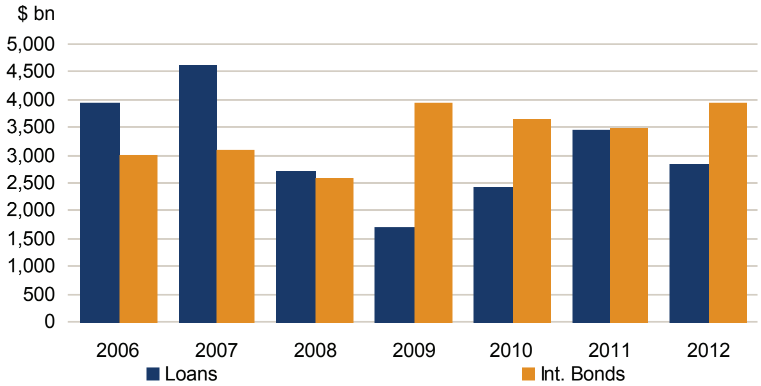
Source – Dealogic, 26 February, 2013

Graph 9: International corporate bond market use of proceeds



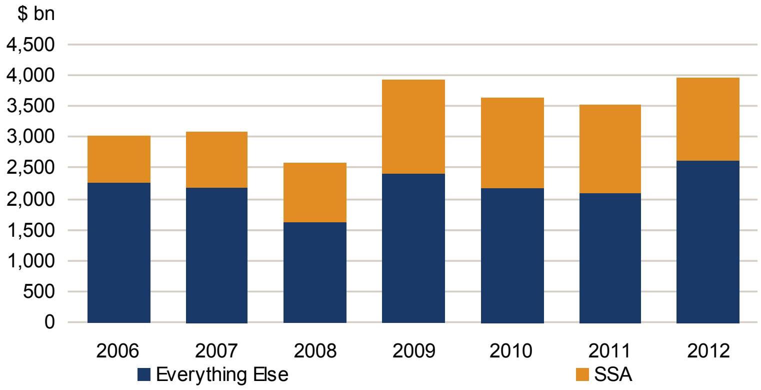
Source – Dealogic, 26 February, 2013

Graph 10: International bank loan v bond volumes



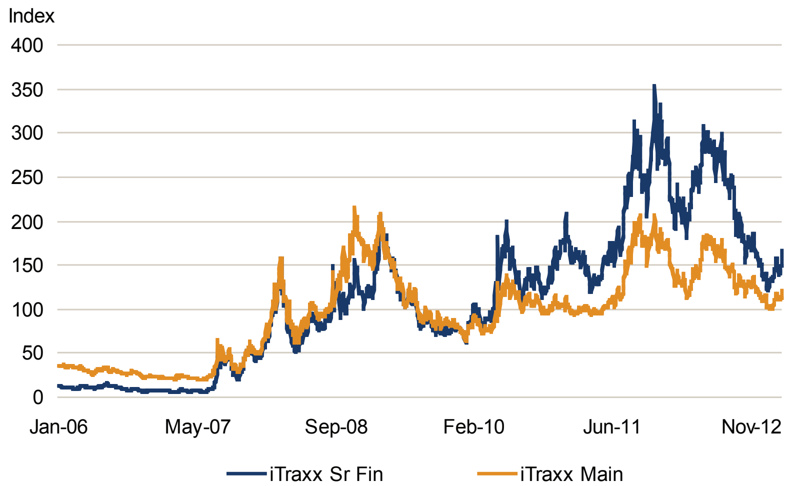
Source – Dealogic, 26 February, 2013

Graph 11: International sovereign and supranational authority bond volumes



Source – Dealogic, 26 February, 2013

Graph 12: Bank funding costs v General credit spreads



Source - Bloomberg

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